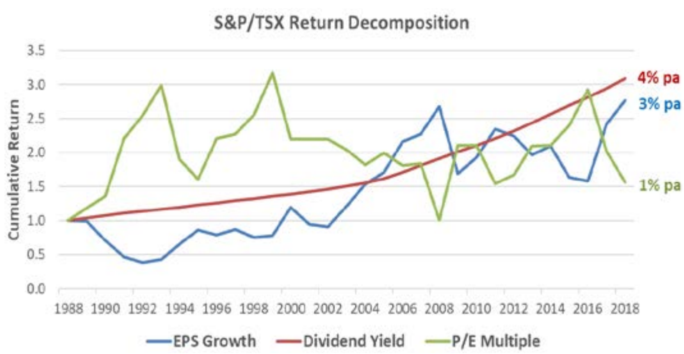
Long-Term Returns to Shareholders

After a dismal 2018, the S&P/TSX Composite Index is positioned to have one of its best performing years in a decade. Year-to-date through November 30th, the TSX delivered a total return of 22.3%, which is well ahead of its 30-year annualized total return of 8.0%. With such a strong absolute return so far in 2019, it might come as a surprise to learn that the index's earnings per share (EPS) growth has declined nearly 5.0% from a year ago.

In simple form, we can think of total returns to shareholders as derived from three key components: EPS growth, the dividend yield, and the change in multiple (price to earnings ratio). Negative EPS growth and a dividend yield of 3.0% suggest that TSX returns this year have come almost exclusively from an expansion of the P/E multiple. As the stock market is said to be "forward looking," investors have looked past the current earnings environment in anticipation of what the future may bring. Valuation multiples are essentially sentiment indicators, and following two years of poor sentiment, investors are seemingly more positive today on factors that could reinvigorate Canadian corporate profitability, such as further interest rate cuts, a US-China trade deal, resynchronization of global growth, etc.

However, history has shown that changes in the multiple have been fickle – in the end, they do reflect investor psychology. While multiple expansion has been the biggest driver of returns in the ten years following the 2008 crisis, we feel it is apt to remind investors that over longer time periods, dividends and EPS growth have generated close to 90.0% of total returns. In the past 30 years, dividends and EPS growth have, on average, delivered 4.0% and 3.0% of return per annum ("pa"), respectively (see chart). Furthermore, dividends have displayed the most stability over time.



Source: QV Investors, RBC Capital Markets

As part of our bottom-up approach to investing, our investment team uses valuation multiples to identify areas of the market showing optimism and pessimism. But we cannot rely on this alone to generate long-term value add for our clients. In constructing our portfolios, we believe it is important to hold a stable of businesses that have demonstrated consistent growth in earnings and cash flow over many cycles. For this reason, long-time followers of QV have, on more than one occasion, heard us emphasize companies like CN Railway – a top 3 railroad in North America, Saputo – a global scale dairy processor, and Canadian Utilities – an Alberta-based provider of gas and electricity. At the core of our portfolios, we partner with capable management teams and franchises that have the capacity to continue growing into the future. Doing so increases our odds of being rewarded through earnings compounding and dividend growth. In turn, it allows our clients to enjoy attractive risk-adjusted returns over time.

Power Financial Corporation (PWF), a recent success within the top-ten holdings of the QV Canadian Equity Strategy, captures our process well. PWF is a holding company with primary investments in life insurance and wealth management. We added to our shares near record low multiples in late 2018. The company has struggled to deliver meaningful EPS growth lately, but has a 20-year track record of 6.2% per year. Its dividend has increased at an average rate of 10.2% per annum over this period and yielded 5.6% before today. This morning, PWF shareholders received an acquisition proposal from parent company Power Corporation of Canada. PWF shares are up close to 40% year-to-date.

Investing will always be a balancing act amongst the three key drivers of returns. As we prepare to roll our calendars forward, we conclude with a few tips: set your eyes on the best companies, have courage to own them when others won't, and be patient – it can take time for the market to realize value, but a good business will keep compounding in the meantime!

QV would like to wish you and your family all the best over the holiday season. Our QV Update will resume in the New Year.